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CALCULATING DAMAGES IN INCOME TAX MALPRACTICE LITIGATION

William J. Michiels

Damage computations in tax malpractice litigation are often more complex than the litigants and their advisors anticipate. Therefore, a CPA who is engaged as a damage expert should be prepared to provide early warning of unexpected issues that may arise. These issues often include (1) the taxability of the plaintiff's recovery, (2) the degree to which the plaintiff mitigated its damages, (3) certain time value of money issues, and (4) assessment of tax attributes and probable results of tax controversies that have not yet been resolved or even discovered by the tax authorities.

The nature of the damage computations may depend on legal factors such as the cause of action and the state law that will be applied.[1] To illustrate the principles described in this article, I have used examples from my tax malpractice litigation engagements which seem to be applicable to most causes of action.[2]

TAXATION OF THE PLAINTIFF'S RECOVERY

Lost profits and most other forms of damage computations are usually calculated on a pre-tax basis, although this practice is frequently debated. In lost profits cases, the plaintiff's prior taxable income has already been reduced due to lower pre-tax profits. Since the subsequent recovery of pre-tax lost profits is taxable, the plaintiff is said to be restored to after-tax parity; it receives a tax benefit when profits are lost and a tax cost when the recovery is received. However, between the date of damage and the date of trial there are inevitably changes in plaintiff's marginal tax rates and tax position as well as in the tax law. As a result, the tax benefits of pre-tax losses often do not equal the tax costs of pre-tax recoveries.

As in lost profits cases, damages in personal injury cases are often computed on a pre-tax basis even though only a portion of the recovery may be non-taxable. Another reason for ignoring tax considerations in such cases is said to be that the analysis of taxation is inordinately complex and, in the case of future tax events, highly unpredictable.

The above-mentioned reasons for calculating pre-tax rather than after-tax damages are very difficult to apply to income tax malpractice cases. This is particularly true if overpaid income tax is a major component of damages. For instance, if damages consist only of overpaid taxes, a pre-tax damage calculation would always equal zero. Furthermore, additional taxes paid as the result of malpractice often result in timing differences which will eventually reduce tax in future periods, a situation which is unusual in other types of litigation. The effects of such tax reversals in

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[1] *Accountant's Liability,* by Dan L. Goldwasser and M. Thomas Arnold (Practicing Law Institute, 1996), describes these and other legal considerations.

[2] This article does not discuss damage computations in securities law cases in which there are losses of tax benefits associated with the purchase of failed tax-oriented investments, in addition to losses of pre-tax investment value.

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future periods can seemingly only be measured by an after-tax calculation unless they are to be ignored.

Finally, the complexity and unpredictability of tax law is the very topic of malpractice litigation. It is difficult to present a credible position that addresses the nuances of tax law in order to address the question of defendant's liability, but not for measuring damages.

RECOVERY COMPONENTS

The components of income tax malpractice damages may include recovery of federal and state income taxes, various forms of the time value of money (including interest assessed by the tax authorities), and penalties. Recovery of legal fees to conduct the malpractice litigation is generally not available. However, plaintiff may seek recovery of fees paid to the defendant, or to new advisors who attempt to deal with tax problems allegedly caused by the defendant.

In an after-tax damage computation, it is necessary to determine which of these components will be taxable when they are recovered, so that damages can be "grossed up" to account for the tax which must be paid. Consider the following example: the defendant's malpractice resulted in a $1,000 nondeductible tax payment by the plaintiff to the IRS. (In this article, the term IRS sometimes refers to any taxing authority.) If the recovery will be taxable at the plaintiff's 40 percent marginal tax rate, a damage calculation of $1,667 ($1,000 divided by [1-.40]) is necessary in order for the plaintiff to pay tax and achieve after-tax parity of $1,000.

In another example, let's assume that defendant's actions caused plaintiff to make an unnecessary payment of $10,000 to the IRS, $4,000 of which was for underpaid taxes, and $6,000 for interest which plaintiff deducted at a 40 percent rate when it was paid. The plaintiff's after-tax damages were therefore $7,600 ($4,000 of tax, plus 60 percent of $6,000, or $3,600, of interest). If plaintiff's marginal tax rate at the time of trial is 34 percent, and damages are computed on an after-tax basis, plaintiff will be entitled to a $9,450 award, not $10,000. The $9,450 amount consists of a $4,000 nontaxable return of capital and a $5,450 payment related to interest paid to the IRS which, after 34 percent tax, will equal $3,600.

Unfortunately, in many circumstances the tax law is not clear as to which portion of the tax malpractice recovery will be taxable. This complicates determination of the taxable and nontaxable components of the damage recovery, which is necessary to perform an after-tax damage computation.

The general tax rule is that a taxpayer recognizes taxable income if another party pays for his or her taxes, unless otherwise excluded by the tax law.[3] However, if a tax preparer makes an error resulting in the client paying more tax than is required, and the error is not detected until it is too late to file an amended return, the plaintiff's recovery will be tax free as a recovery of capital according to Revenue Ruling 57-47.[4] Not surprisingly, tax practitioners have attempted to

[3] Reg. § 1.61-14(a).

[4] 1957-1 C.B. 23. Also see *Clark v. Commissioner,* 40 B.T.A. 333 (1939). Acq., 1957-1 C.B. 4. Also, in some cases which relate to acquisitions or dispositions of assets, it is possible that recoveries from tax advisors will be taxed at capital gains rates.

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broaden the application of the position that recoveries are returns of capital, while the IRS has in recent years attempted to limit the application of Revenue Ruling 57-47.

PRIVATE LETTER RULINGS ON TAXABILITY OF MALPRACTICE DAMAGES

The IRS's attempts to clarify and limit the application of Revenue Ruling 57-47 appear in several Private Letter Rulings (PLRs). A PLR is directed only to the taxpayer that requested it and does not have formal precedent-setting value for other taxpayers. However, PLRs are analyzed by practitioners as indications of the IRS's thinking on particular topics.

The IRS's view as expressed in these PLRs is that certain recoveries for tax malpractice are taxable.[5] In general, according to older PLRs recoveries are taxable when they represent payments for the loss of tax benefits that were to have been provided by tax-favored transactions. However, the tax principles involved in reaching the conclusions in these PLRs are not applied consistently, particularly with respect to such issues as the taxability of recoveries for penalties and interest.

A recent PLR, LTR 9728052, however, seems to offer additional insight into the IRS's view of the proper application or limitation of the principles of Revenue Ruling 57-47. In this case, an attorney's client entered into an agreement to pay an ex-spouse certain amounts for a specific term of years. If the ex-spouse died before the end of the term, the remaining payments would be made to her estate. The attorney was to have prepared the agreement so that the payments would be deductible by the client as alimony. An IRS examination properly disallowed prior deductions for the payments, because the possibility that any of the payments would continue after the ex-spouse's death precluded alimony classification for all years in which payments were made. The client sought reimbursement from the attorney's malpractice carrier for additional taxes, interest, and penalties paid to the IRS as the result of the examination, as well as the expected tax costs of future tax payments. The client requested a ruling as to whether the payment to be received from the carrier was taxable, perhaps in order to determine whether he should negotiate with the carrier for a grossed-up payment.

The IRS ruled that all elements of the recovery would be taxable, reasoning that given the terms of the agreement, the client (after the IRS examination) paid the proper amount of tax. In other words, the malpractice claim resulted from erroneous drafting of the contract terms, not the improper preparation of the tax return. This interpretation contrasts with the circumstances in Revenue Ruling 57-47, in which the taxpayer paid more tax than was properly due given his circumstances.

PLR 9728052 also states that the plaintiff's recovery of interest and penalties paid to the IRS is taxable. It notes that the interest and penalties were the proper amounts owed based on the facts that existed at the time of the audit and, since the reimbursement of taxes would not be a return of capital, neither would the reimbursement for interest and penalties.

The taxability of reimbursements for penalties, interest, and state income taxes is usually considered to be determined by the tax benefit rule of IRC §111.[6] Briefly, the tax benefit rule as it typically relates to tax malpractice cases is that to the extent that items such as interest or state tax payments provide a tax benefit when originally paid, a subsequent recovery will be included in taxable income.[7]

PLR 9728052 seems to ignore the tax benefit rule and looks to the nature of the claim to determine whether all or none of the elements of the recovery is taxable.[8] Although

To Our Readers: Although this issue of CPA Expert *is a double issue (Spring/Summer 1998), subscribers will receive four issues this year. A special issue will be published later this year.*

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[5] Further discussion of the development of the IRS's position and the underlying law in this area can be found in Robert W. Wood's *Taxation of Damage Awards and Settlement Payments*, (Tax Institute, 1991) ¶4.25, including its subsequent annual Cumulative Supplements. Similarly, see William L. Raby and Burgess J.W. Raby, *Tax Notes Today*, July 24, 1997, (Tax Analysts, 1997).

[6] Since federal income tax is not deductible, a recovery for overpaid tax would seemingly not be taxable under the tax benefit rule. Also, there are specific procedures for applying the tax benefit rule in particular circumstances not discussed herein.

[7] The increase in a net operating loss carryover will be considered to be a tax benefit for this purpose. Also, the tax benefit rule creates taxable income in the year of recovery, so that its operation is unaffected by the statute of limitation on assessments for the year of the deduction.

The damage expert will have to keep track of and discuss several hypothetical and actual events that correspond to the various mitigation scenarios put forth.

the results in PLR 9728052 may be consistent with the application of the tax benefit rule, the fact that the PLR does not discuss the application of the tax benefit rule leaves uncertainty about the method of its applicability in other circumstances.

Further discussion of the tax law relating to tax malpractice recoveries is beyond the scope of this article. The principal point is that the law is not completely clear on this topic.

Finally, it should be noted that most tax cases in which enough is at stake to require a thorough damage analysis do not seem to relate to the exact type of tax return preparation errors described in Revenue Ruling 57-47. Instead, they relate to lack of proper advice, errors in structuring transactions, or ineffective dealings with the IRS including failure to file timely tax returns and other documents.

DID PLAINTIFF PROPERLY MITIGATE ITS DAMAGES?

The tax malpractice damage expert can expect to prepare and present several alternative damage calculations during the course of the engagement. One reason that multiple scenarios are necessary is that the defendant frequently asserts that the plaintiff's new tax advisor (i.e., the defendant's successor) did not take appropriate actions in order to mitigate plaintiff's damages.

The damage expert's calculations may need to reflect the effects of the different actions that the successor advisor should have taken. Since there are often several views as to the appropriate nature and timing of such mitigating actions, the number of scenarios to consider can quickly multiply.

For instance, a common defendant's theory is that the successor should have detected the defendant's alleged errors earlier, so that payments could have been made to stop the running of interest, even if the subsequent resolution of the tax controversy would have been unsuccessful. Similarly, it is often asserted that earlier or better recognition of the tax problems at issue would have permitted timely or more effective resolution at the examination, appeal, or Tax Court level. The successor may be accused of failing to apply for changes in plaintiff's tax accounting methods, obtain penalty abatements, or avoid or mitigate tax calamities such as inadvertent S-corporation terminations and creation of personal holding companies. The defendant may also criticize the successor's failure to accept IRS settlement offers for disputes allegedly caused by the defendant. This intense scrutiny of the successor's actions may even result in the successor becoming another defendant.

Parties inexperienced in tax malpractice cases may not realize at the outset that someone may have to offer testimony about the appropriateness of the successor's actions as well as those of the defendant. If the damage expert is not designated to offer such opinions or is not provided with the appropriate information to do so, he or she should be quick to advise the client that such testimony will be necessary.

The damage expert will have to keep track of and discuss several hypothetical and actual events that correspond to the various mitigation scenarios put forth. It may be helpful to prepare a timeline that reflects the historical cash flows of the plaintiff as well as the tax deadlines for filing protests, Tax Court petitions, and amended returns. These dates may be the actual deadlines as well as those that would have occurred in different mitigation scenarios.

TIME VALUE OF MONEY CONSIDERATIONS

There are several time value of money considerations involved in most tax malpractice cases. One such consideration not to be found in other commercial damage calculations arises when taxes were paid long after they were properly due, as the result of defendant's errors that are detected by subsequent IRS audits and may take years to resolve. The plaintiff is unable to recover damages for the tax component of the amount paid to the IRS if the tax liability and the amount were inescapable.

[8] Noncorporate taxpayers are unable to deduct "personal" interest, as opposed to interest that is properly allocable to a trade or business or certain other types of interest. Temporary Regulation §1.163-9T (b) (2) (i) indicates that interest on federal, state, or local income tax underpayments, and on debt used to pay such taxes, is always personal in nature even if the source of income generating the tax liability is a trade or business. The Tax Court (*Redlark v. Comm.,* 106 TC 31, 1996) and a District Court (*Allen v. US,* DC N.C. 98-1 USTC) found that the regulation is invalid. In the Eighth Circuit, the Court of Appeals upheld the Regulation (*D. Miller,* CA-8, 95-2 USTC ¶50,485), and most recently, the Ninth Circuit reversed *Redlark* and upheld the regulation (CA-9, 98-1 USTC ¶50,322).

In such cases, damage computations relate to the penalties and interest ultimately paid, which are often larger than the taxes at issue. The defendant will contend that damages should be reduced to account for the plaintiff's benefit arising from paying tax long after it was properly due.

In these cases, an issue is the rate used to measure the amount of benefit obtained by the plaintiff for the use of funds between the proper due date of the taxes and the date they were actually paid. If the plaintiff's rate of return on the use of the funds approximates the rate of interest assessed by the tax authorities, damages may be minor.

Some courts have held that damages can be awarded without considering such an offset to interest paid.[9] Defendants will tend to argue that a high offset rate should be used, particularly if the plaintiff experienced high rates of return on investments or assets employed in its business. The damage expert is left without much guidance from the law as to how to select offset rates.

The determination of the rate of return earned by plaintiffs while tax payments are deferred is not always straightforward. This is particularly true for individual taxpayers, where it is sometimes difficult to say how the cash flow from late payment of taxes was actually invested or spent. In these cases, it may be tempting to use government bond returns, as are used to compute the time value of money in most lost earnings or personal injury damage calculations. However, this may provide plaintiffs with an inappropriate advantage since these risk-free rates are much lower than those charged by the IRS on underpayments of tax. Sometimes, interest rates published by the IRS for other tax purposes such as imputing interest on loans may be used if they have some relevance to the plaintiff's financial profile.

Whether or not damages are being computed on a pre-tax or an after-tax basis, returns on plaintiff's delayed tax payments should normally be computed on an after-tax basis, unless plaintiff's investment returns were tax-free or tax deferred for some reason. Assume that plaintiff earned 6 percent before tax on assets and had a 33 percent tax rate for all periods. The plaintiff's time value of money gained should be calculated as the amount of tax deferred, at a 4 percent compound rate (6 percent x (1–.33)) for the period prior to the payment to the IRS. If the plaintiff's recovery will be taxable and the calculation is performed on an after-tax basis, the resulting value should be grossed up using the plaintiff's current tax rate (in this case, dividing it by 1–.33). This procedure will result in a different amount than if pre-tax investment rates were used and the result was not grossed up, because interest is compounded differently under the two methods.

I suggest that the damage calculation separately identify each of the components of time value of money. These components include the amounts of interest and interest-like penalties paid and accrued, the offset to those amounts arising from the plaintiff's use of funds, and the effect, if any, of taxes on these cash flows. This will facilitate changes to the damage calculations as they evolve and allow easier presentation in depositions and other presentations.

VALUING AND PREDICTING FUTURE EVENTS

Damage computations in commercial disputes commonly value uncertain future cash flows. Tax malpractice cases, however, have peculiar issues in this regard.

The plaintiff's acts may result in the unnecessary or early use of net operating losses or other tax attributes, rather than resulting in cash payments prior to the time of trial. The ultimate damage to the plaintiff will not be known with certainty until it is determined if, how, and when the carryforwards or other attributes will be utilized.

Similarly, overpayments of taxes, improper tax elections, or failure to make such elections may have future consequences which are not easily valued. Assume, for instance, that a 1991 IRS audit of a 1989 tax return reveals an improper structuring of a partnership transaction, thereby creating $500,000 of taxable income to partners. It would be common for the partners to have additional adjusted basis in their partnership interest and in some underlying asset or tax attribute as a result of the audit adjustment. At the time of trial or settlement in 1998, the additional tax basis may not have provided a cash flow benefit, as would have occurred if the

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Damage computations in commercial disputes commonly value uncertain future cash flows.

[9] Goldwasser and Arnold, p. 83.

SOLVING THE MYSTERIES OF THE PYRAMIDS

Karl J. Schulze, CPA

The pyramid has always been shrouded in mystery. Ancient civilizations used pyramids not only as tombs, but also as religious and cultural sites. In modern times they often continue to be seen as harboring special spiritual or recuperative powers.

There is no question that the pyramid structure plays a pervasive role in business and finance. Few enterprises of even moderate size could operate effectively without a pyramidal organizational hierarchy. Similarly many legitimate businesses operate under a multilevel marketing (MLM) concept, whereby a product is distributed through a network of independent representatives, each of whom may recruit other representatives (their "downline") in whose earnings they will participate. This arrangement has worked successfully for many familiar products. Amway and Avon are examples.

Pyramids in the business world, then, are not illegal in and of themselves. A pyramid-structured business crosses the line into illegality when emphasis is placed on earning "income" from the recruitment of new participants in the pyramid rather than from the sale of products to the public. New recruits in such a scheme are normally required to pay for the privilege of becoming a representative. Sometimes product does change hands, but it is merely the shifting of inventory to one's downline rather than a legitimate sale to a third party.

Another form of illegal pyramid was quite popular for a period in the late '70s and early '80s and continues to surface from time to time. In these schemes no product at all is involved; new members pay in, knowing that their only way to recover their "investment" and make a profit is to continue to build the pyramid below them by enlisting additional participants.

The Ponzi scheme, which takes its name from Charles Ponzi, an early 20th Century con man, is an investment swindle in which funds raised from investors are misappropriated in some manner. Early investors are appeased, or provided an apparent return on their money, from funds taken from later investors. A Ponzi scheme eventually fails, since an ever-growing pyramid of investors is required in order to keep it alive, and there is a practical limit on how many can be recruited.

Many Ponzi schemes are in the form of franchise operations. The basis of the scheme is to sell or purport to sell the right to distribute or sell a product. The franchises are sold to people who hope to sell subfranchises. The scheme generally collapses when the selling chain can find no more participants.

While a Ponzi scheme is a type of pyramid scheme, the two are not exactly the same. A Ponzi scheme generally promotes itself as a legitimate investment opportunity, and, in fact, often starts out as just that. The promoter may very well have an actual asset or intend to buy legitimate assets with investors' funds, but soon begins to misdirect funds, and the fraud begins. A Ponzi scheme is generally not represented to investors as being pyramidal in structure. The pyramid concept arises out of necessity as the promoter recruits ever more investors to provide cash "to buy the silence" of earlier participants so that the scheme can continue.

Participants in a Ponzi scheme believe they are investing in a viable asset or enterprise and that returns will come from the development or sale of those assets. Participants in a pyramid scheme, however, realize going in that they will achieve a return through recruitment of others.

SOME RECENT EXAMPLES

The classic scheme has in recent years taken on numerous forms limited only by the creativity of the criminal mind. The following are a few examples:

▲ *New Era Philanthropy.* The promoter of this scheme promised charitable organizations that it could raise matching donations, if only the charities would put up good-faith money to be held in escrow. The money was not put in escrow, and the only matching funds delivered came from other unsuspecting charities.

▲ *A New York attorney* raised more that $25 million from investors, promising them a 30-percent return on the import of whiskey from Scotland. The attorney used some funds to pay personal debts, gave some to family mem-

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bers, and used a small amount to pay the promised 30-percent return to early investors.

▲ *A Florida company* promised investors returns of between 20 percent and 40 percent on the arbitrage of grocery items nationwide, raising approximately $250 million for what ultimately proved to be nothing more than a classic Ponzi scheme.

▲ *A California-based series of limited partnerships* raised more than $50 million for the acquisition and restoration of historic buildings. No buildings were ever acquired or restored. Most of the $50 million went to support the promoter's lifestyle. Very little was recovered, and the promoter is currently serving a long jail term.

▲ *A travel agent training program* supposedly would enable its graduates not only to enter the travel profession, but also to receive tremendous discounts on worldwide travel. The sale of additional distributorships was highly emphasized, and no real training was ever provided.

Certain products have seemed to attract Ponzi artists in recent years. There have been numerous instances of pyramid schemes involving precious metals, vitamins, real-estate second mortgage notes, and travel schemes, taking literally hundreds of millions of dollars from investors before collapsing. The growing popularity of and access to the Internet has spawned numerous scams—what better way to reach thousands of potential victims.

HOW CPAs GET INVOLVED

CPAs usually become involved in services related to pyramid and Ponzi schemes as expert witnesses or consultants in civil litigation. CPAs are often asked to help identify the factors that determine whether a particular situation is a pyramid or Ponzi scheme. They are also asked to unravel the maze of financial transactions usually involved in such schemes in order to determine who was enriched and who suffered losses. CPAs are then often designated as testifying experts in order to present to the trier of fact a clear picture of the flow of funds. CPAs can also become involved as a consultant in criminal proceedings or when results of the investigation will likely lead to criminal prosecution.

TELLTALE SIGNS

Unfortunately, occasionally a prospective client's business demonstrates traits that suggest a pyramid or Ponzi scheme is underway or in the making. It is important then to be aware of the following basic warning signs:

▲ A promised return in excess of 20 percent may have more risk than even an aggressive investor is willing to take and may prove to be impossible to achieve.

▲ An extravagant lifestyle on the part of someone involved in an early stage of the enterprise.

▲ A promoter who asks you to trust him or her.

▲ Multilevel marketing (MLM) opportunities that unduly emphasize recruitment of others as a means to earn returns.

▲ MLM schemes that hold large recruitment meetings that have the feel and fervor of a religious revival meeting.

▲ An organization's products are either not viable or are so overpriced as to make sale to the public difficult. This may be a sign of something other than a legitimate enterprise.

▲ Requirements that representatives pay a significant fee or buy an overpriced sales starter kit. This may be evidence of an illegal pyramid scheme.

▲ Promoters avoid clear explanations or keep changing their stories.

▲ The unavailability of financial statements of the company or unwillingness of the principals to discuss them.

▲ A procedure does not make sense. After a request for further explanation, it still does not make sense. Therefore, it may mask improper activities.

▲ A promoter requests "good faith" money and tells prospective victims that they must move quickly.

▲ Individual's names are promoted as ref-

Responding to Proposed Pyramid and Ponzi Schemes

In addition to providing services as investigators of pyramid and Ponzi schemes, CPAs can serve clients by providing them the following advice when they are offered an attractive investment opportunity:

- **If the offer sounds too good to be true, it probably is.**
- **Investigate whether any products are actually being sold.**
- **Ask for proof of transactions. Have the CPA follow the trail and determine the parties involved.**

Always investigate the history of the company and the person soliciting business.

Fraud Investigations

When CPAs are retained to investigate the possibility of a pyramid or Ponzi scheme or other fraud, they need to address several issues that are discussed in AICPA Consulting Services Practice Aid 97-1, *Fraud Investigations in Litigation and Dispute Resolution Services: A Nonauthoritative Guide* (New York: AICPA, 1997). The following excerpts outline some of these issues:

FRAUD INVESTIGATION PREDICATION

At the beginning of a fraud investigation, the CPA should have a sufficient fraud predication. Companies, individuals, and others often fear a loss of reputation if they are the target of or are implicated by a fraud investigation. The CPA may benefit from establishing that the fraud suspicions are alleged by others on whose behalf the CPA is working. This arrangement places the client between any target of the CPA's investigation and the CPA, and helps protect the CPA from legal complaints filed by any individual alleging reputation damage caused by the inquiry. In addition, some CPAs ask the client for written authorization to interview employees and other people, and to give them access to documents and files.

CONVERSATIONS WITH NON-CLIENT-RELATED PARTIES

If approached by counsel for non-client parties for information, CPAs should not provide any without specific written instructions from the client's attorney. If CPAs receive a formal request for discovery from adverse parties, they would coordinate any response with the client, client's counsel, and, if needed, their own counsel. CPAs should also be careful to comply with Rule 301 of the AICPA Code of Professional Conduct concerning confidentiality of client information, as well as similar professional standards and regulations established by state CPA societies, state boards of accountancy, and state accountancy laws.

CONDUCTING INTERVIEWS

During an interview with a target of the investigation, the interviewee may reveal information that implicates him or her in the fraud scheme, and such information could be used against the individual in a subsequent legal proceeding. The interviewee may confess or "roll over." If so, the CPA should have an observer present and take detailed notes. If the perpetrator is willing to issue a written statement, the CPA should allow the individual the opportunity to do so. A statement may be prepared by the CPA and signed by the interviewee, or the interviewee may prepare the statement and sign it.

DISCLOSING FINDINGS OF POTENTIAL FRAUD

CPAs do not normally disclose an apparent fraud to law enforcement authorities, regulators, or potential victims of the fraud scheme without the clear consent of the client or the client's legal representative. Whenever there is a doubt concerning responsibilities, the CPA should refer to the applicable professional standards and consult with the appropriate legal counsel.

The practice aid discusses these issues in much more detail, of course, and provides additional guidance to CPAs about approaching and reporting on investigations involving potential fraud. To obtain a copy, call the AICPA Order Department at 888-777-7077 and ask for product no. 055001MCS.

erences, but their motivation for involvement in the enterprise is unclear.

INVESTIGATIVE TECHNIQUES

Once the CPA is retained to investigate, unravel, and possibly testify regarding an alleged Ponzi or pyramid scheme, he or she would apply certain of the following investigative techniques.

▲ *Interviews* with participants and victims.

▲ *Review of financial records,* including cash receipts and disbursements journals, as well as bank statements and canceled checks. Surprisingly, operators of Ponzi schemes often maintain an accurate set of books.

▲ *Analysis of financial transactions,* which is the most common tactic in determining the flow of funds in a pyramid scheme. Frequently, financial records are not available, so the CPA must attempt to recreate the flow of funds on a transaction-by-transaction basis in order to determine the amount of investor funds raised and the disposition of those funds. Information obtained from the bilked investors themselves, such as canceled checks, may be helpful. Sometimes, however, it is impossible to retrace the flow of funds.

▲ *Review of other documents,* such as representatives' contracts and investor agreements.

▲ *Review of public records,* such as those maintained by professional licensing agencies, courts, the Securities and Exchange Commission, the Better Business Bureau, and credit reporting agencies. These records can provide evidence regarding the previous activities or method of operation of a suspected pyramid or Ponzi scheme promoter.

▲ *Undercover work.* Although not what a CPA is trained in, undercover work is an extremely effective investigative technique. It can be as simple as calling an information line and asking the questions as a prospective sales representative or customer might ask. The CPA should undertake any more complex undercover work, such as impersonation or infiltration, only after consulting with legal counsel.

▲ *Surveillance,* which can be as simple as watching a promoter in action or observing the handling of funds.

In addition, many of the methods useful in analyzing or reconstructing pyramid schemes are similar to those used in auditing, such as analytical procedures and third party confirmation.

As investigator and potential expert witness, the CPA needs to be careful to avoid compromising the objectives of the engagement or risking liability by inadvertently using improper investigative techniques. A useful overview for investigations that may involve fraud is provided in AICPA Consulting Services Practice Aid 97-1, *Fraud Investigations in Litigation and Dispute Resolution Services: A Nonauthoritative Guide* (New York: AICPA, 1997). (See the sidebar "Fraud Investigations" on page 10.)

Mr. Ponzi's legacy will not die as long as there is an ample supply of gullible and greedy investors. By remembering the above points, we and our clients can avoid being victims. (See also the sidebar, "Responding to Proposed Pyramid and Ponzi Schemes.") A CPA, who is trained as an investigative accountant, can be in a position to assist legal counsel and prosecutors in recovering assets on behalf of those who have been victimized. CE

TAX PENALTIES RELATED TO VALUATION ISSUES

by Robert F. Reilly, CPA, ASA, CFA

Several taxation-related penalties can be assessed as a result of adjustments made to valuations prepared for income tax returns (for example, charitable contributions) as well as for gift and estate tax returns. Although most of these penalties are assessed against the taxpayer, certain penalties may also be assessed against the tax-return preparer.

Some penalties deal exclusively with valuation issues, and some penalties related to general accuracy may be applicable to valuation issues. The current penalties related to valuation issues are provided for in the tax law enacted since the passage of the Omnibus Budget Reconciliation Act of 1989 (OBRA).

CPAs who perform valuations for tax purposes should be familiar with these penalties as should be CPAs who prepare tax returns that include valuations, even if the valuations were done by other consultants.

SECTION 6662 ACCURACY-RELATED PENALTIES

OBRA consolidated several accuracy-related taxation penalties into one Internal Revenue Code section, Section 6662. The penalties include:

1. The negligence penalty (previously assessed under Section 6653(a))
2. The substantial understatement of income tax penalty (previously assessed under Section 6661)
3. The substantial valuation overstatement penalty (previously assessed under Section 6659)
4. The substantial estate or gift tax valuation understatement penalty (previously assessed under Section 6660)
5. The substantial overstatement of pension liabilities penalty (previously assessed under Section 6659A)

The accuracy-related penalty is applied to the portion of any underpayment of tax that is attributable to one or more of these five issues. All accuracy-related penalties apply to tax returns due, without regard to extensions, after December 31, 1989.

The old versions of these penalties were repealed under OBRA. The new versions of the penalties under Section 6662 have the same penalty rate of 20 percent of the tax underpayment. The penalty rate increases to 40 percent of the tax underpayment when there is a "gross valuation misstatement" as defined under Section 6662(h)(2).

Only two accuracy-related penalties are limited exclusively to valuation issues: the Section 6662(e) substantial valuation overstatement penalty and the Section 6662(g) substantial estate or gift tax valuation understatement penalty. However, the other accuracy-related penalties may be applicable to valuation issues as well. For example, there is

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Some penalties deal exclusively with valuation issues, and some penalties related to general accuracy may be applicable to valuation issues.

nothing to prevent a negligence penalty under Section 6662(b)(1) from being applied to a valuation issue, assuming the facts of the position support the assertion of taxpayer negligence. This is noteworthy because the negligence penalty does not have a minimum threshold of a $5,000 tax understatement, as do the penalties related exclusively to valuation.

The Section 6662 accuracy-related penalties are assessed on an issue by issue basis. And, each of the accuracy-related penalties is applied only to that part of the tax underpayment that is caused by the proscribed conduct.

NEGLIGENCE PENALTY

The negligence penalty, codified at Sections 6662(b) and 6662(c), is applied only to the portion of the tax underpayment that is attributable to negligence. This is a change from prior tax law, which applied the negligence penalty to the entire amount of the tax underpayment. The definition of negligence remains the same as under the prior law.

The accuracy-related penalty will be imposed (1) for negligence in the case of any careless, reckless, or intentional disregard of rules or regulations, and (2) for any failure to make a reasonable attempt to comply with the provisions of the tax law. No penalty is imposed for a tax underpayment resulting from negligence if it can be shown that (1) there was reasonable cause for the tax underpayment, and (2) the taxpayer acted in good faith with respect to the tax underpayment.

SUBSTANTIAL VALUATION OVERSTATEMENT

OBRA made four main changes to the penalty for substantial overstatement in a valuation:

1. The penalty can apply to all taxpayers.

2. A substantial valuation overstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent (up from the previous 150 percent) or more of the correct value or adjusted basis.

3. The penalty applies only if the amount of the tax underpayment attributable to a valuation overstatement exceeds $5,000 ($10,000 for a corporation other than an S corporation or personal holding company). This is a major increase in the threshold: The previous penalty required an understatement of only $1,000 (under the old Section 6659(d)).

4. The amount of this penalty is 20 percent of the tax underpayment if the value or adjusted basis is 200 percent or more—but less than 400 percent—of the correct value or adjusted basis. The penalty is doubled to 40 percent if the value or adjusted basis is 400 percent or more of the correct value or adjusted basis.

The penalty for a substantial valuation overstatement is codified in Sections 6662(b)(3), 6662(f), and 6662(h).

SUBSTANTIAL OVERSTATEMENT OF PENSION LIABILITIES

The regulation concerning substantial overvaluation of pension liabilities was changed so as to be assessable only if the valuation difference is 200 percent or more. The minimum tax underpayment if the pension overvaluation penalty is to apply remains at $1,000. The rate of the tax penalty is doubled to 40 percent, if pension liabilities are overstated by 400 percent. This penalty is codified in Sections 6662(b)(4), 6662(f), and 6662(h).

ESTATE OR GIFT TAX VALUATION UNDERSTATEMENT

The penalty for understatement in an estate or gift tax valuation is based on the prior law of old Section 6660. OBRA modified the prior law by providing that a taxpayer is subject to the penalty only if the value of property that is reported on the tax return is 50 percent or less of the correct value. Under prior law, the penalty applied to cases in which 66 percent or less of the correct value was reported. Moreover, the new law increases the tax understatement threshold below which the tax penalty will not apply from $1,000 to $5,000. This penalty is codified in Sections 6662(b)(5), 6662(g), and 6662(h).

The rate of this tax penalty is 20 percent in normal cases. The rate of the penalty is doubled to 40 percent, however, if 25 percent or less of the correct value is reported for estate and gift valuation purposes. The rules for this increase are detailed under Section 6662(h).

6664 DEFINITIONS AND SPECIAL RULES

The penalties under Sections 6662 and 6663 apply only if a tax return is filed. For this purpose, a tax return does not include a return filed under Section 6020(b), whereby the Service filed the return based on information available. It is noteworthy that fraudulent failure to file a tax return is covered by Section 6651(f).

Under Section 6664(c), no accuracy-related penalties will be imposed if (1) there was reasonable cause for the tax underpayment, and (2) the taxpayer acted in good faith. Section 6664(c)(2) also states that the valuation overstatement penalty will not apply to charitable contribution property if:

1. The claimed value was based on a "qualified appraisal" by a "qualified appraiser" as defined in Section 170(a)(1).
2. In addition to the appraisal, the taxpayer made a good faith investigation of the value of the property.

TAX-RETURN PREPARER PENALTIES

Tax-return preparers are subject to a different set of tax penalties than are taxpayers. First, preparers may be assessed a $250 penalty under Section 6694(a) for any tax return that understates a taxpayer's tax liability due to an undisclosed position that could not possibly be sustained on its merits. Second, preparers may be subject to a $1,000 penalty under Section 6694(b) for any willful, reckless, or intentional understatement of tax liability. This Section 6694(b) penalty could apply to a valuation-related tax understatement.

The application of tax penalties becomes a somewhat ambiguous issue in two instances:

1. There is a substantial—but legitimate—difference of valuation opinions between the Internal Revenue Service and the taxpayer.
2. The taxpayer reasonably relies upon an accountant for a valuation position.

Both of these issues were present in *Estate of Berg v. Commissioner* (US Court of Appeals for the Eighth Circuit, No. 91-3198, October 5, 1992). Although this case is a few years old, it still provides valuable guidance with respect to tax penalties.

This Circuit Court case is an appeal of a Tax Court decision in which the judge upheld the Service's application of a 10-percent penalty under (now repealed) Section 6660. The valuation issue in this case relates entirely to the appropriate amount of discounts for (1) lack of control and (2) lack of marketability. When filing the return, the estate relied upon the analysis of a prominent CPA who concluded valuation discounts of 40 percent for lack of control and 20 percent for lack of marketability.

The Tax Court found the testimony and analysis of the CPA to be unpersuasive. The Court agreed with the government's (nonCPA) appraiser, who concluded appropriate valuation discounts of 20 percent for lack of control and 10 percent respectively. The Tax Court also imposed on the estate the Section 6660 10-percent penalty for understating its tax liability.

PENALTY DECISION REVERSED

The Appeals Court reversed the penalty and upheld the trial court's conclusion regarding the appropriate valuation discount. While acknowledging that the CPA was not formally trained as an appraiser, the Appeals Court concluded that the estate had reasonably relied upon the CPA's discount analysis. Since the estate reasonably relied upon the CPA's expertise and submitted the estate tax return in good faith, the understatement of tax penalty was not applicable.

CPAs who prepare valuations or advise their clients on tax-related valuation matters should be aware of these penalties. The Section 6662 accuracy-related penalty encompasses the spectrum of income tax, gift tax, and estate tax-related valuation matters (including, for example, the valuation aspects of transfer pricing under Section 482). Moreover, the negligence penalty may be assessed on valuation-related tax disputes if the taxpayer acted in a careless or reckless manner.

In addition, the tax-return preparer could be assessed the Section 6664(b) penalty related to a willful understatement of tax liability associated with an insupportable valuation position. Besides being assessed penalties, the tax-return preparer can be penalized in another way: The names of tax-return preparers who are associated with understatement of tax liability valuation issues are reported to the director of practice of the Internal Revenue Service. If there appears to be a pattern of abusive cases, the preparer's privilege to practice before the Service may be revoked.

Clearly, penalties should not discourage taxpayers or preparers from taking aggressive, but well supported, valuation positions. There may frequently be substantial—but legitimate—differences of opinion between the taxpayer's valuation and the Service's valuation. As the Appeals Court decision in the *Estate of Berg* indicated, penalties will not be applicable if the taxpayer reasonably relies in good faith upon a professional well-supported analysis. CE

Clearly, penalties should not discourage taxpayers or preparers from taking aggressive, but well supported, valuation positions.

Expert Tools

ESTATE PLANNING INFORMATION ON THE INTERNET

Eva M. Lang, CPA

Various business and legal situations bring about the need to know the value of a business. These situations include estate planning, a demanding and complex discipline, often requiring professional valuation skills. The Internet has become a valuable resource for CPAs engaged in estate planning providing a wide variety of information. You can read articles from major estate planning journals, search case law involving estate tax issues, and locate state and federal estate laws.

Unfortunately, for the practitioner there are fewer good estate planning sites than bad or unhelpful ones (a common phenomena on the Internet not limited to the topic of estate planning). Many are blatant advertisements for questionable services and others are misleading or purposely untruthful.

The estate planning sites mentioned below were culled from hundreds of estate planning sites and feature information of interest to the estate planning practitioner.

START WITH THE AICPA

The AICPA site (http://www.aicpa.org) has several resources for CPAs interested in estate planning. Using the search feature of the site turns up a list of educational courses available from the AICPA including *"Estate Planning and Business Succession"* and *"Estate Planning for Family Business Owners."* Courses listed on the AICPA site include self-study and instructor led courses including those taught by State Societies. For example, click on the link for the course *"Family Limited Partnerships"* and you get course information and a schedule. Once you decide upon a course location and date (say you choose the course taught in Atlanta in July) you can click on the related link to the Georgia Society of CPAs and register for the course online.

In addition to educational opportunities, the AICPA site offers a variety of other resources such as articles about estate issues which have appeared in the *Journal of Accountancy*. You can also download booklets from the site on such topics as *"The CPA as an Estate Planner"* and *"Settling an Estate."*

LEGAL SITES

Another good starting point for estate planning information is the Law Journal Extra web site (http://www.ljx.com). This site has set up a special section for those interested in estate planning: http://www.ljx.com/practice/trusts/index.html. This section of the site contains articles, columns, and statutes related to estate planning. A recent featured article on this site was "The Family Foundation as an Estate Planning Tool." Under the *Columns* heading there are a variety of features from various law journals. In March 1998, the focus was on business valuation, with an article from the *New York Law Journal* on "Common Business Valuation Errors." The Statutes section links the reader to federal and state estate law statutes and recent court decisions.

The American Bar Association has a web site for members of its Section of Real Property, Probate and Trust Law (http://www.abanet.org/rppt). This site is open to the public and has a variety of articles and links to estate planning resources. You don't have to be a member to sign up for the ABA-PTL listserv, an e-mail discussion list on estate planning.

The American College of Trust and Estate Counsel is a professional association consisting of approximately 2,700 lawyers from throughout the United States. The web site of the American College of Trust and Estate Counsel (http://www.actec.org) has a limited amount of information accessible to the public. However, the *What's New* section is a good source of news of interest to estate planners.

KNOW THE CODE

It helps to know the code. The Cornell Legal Information Institute has a special section on estate planning law materials (http://www.law.cornell.edu/topics/estate_planning.html). This site contains the full text of the U.S. Code: 26 U.S.C., Subtitle B—Federal Estate & Gift Tax. The site supports a search engine that can search the text of the Code by key word. There are also links to the *Uniform Probate Code* and *the Revised Uniform Principal and Income Act* as well as the relevant state statutes on probate, property, and taxation.

For more statutes, cases and code, be sure

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to check the U.S. House of Representatives Internet Law Library's Trusts and Estates section (http://law.house.gov/112.htm). Here you will find links to state and federal laws relating to estates. There are also dozens of articles on estate planning topics ranging from "Trust in Panama" to "The Truth About Living Revocable Trusts."

THE YAHOO OF LEGAL SITES

Many Internet users turn to Yahoo (http://www.yahoo.com) to begin any search regardless of the topic. Set up in a "yellow pages" format, Yahoo is an invaluable tool for locating Internet sites. But what if you could find a search index similar to Yahoo for legal resources, or better yet, for estate and trust resources? That is exactly what the good folks behind Findlaw have done. They took the search index format popularized by Yahoo and applied it to legal sites. The Findlaw section on Wills, Trusts, Estates and Probate is accessible at http://www.findlaw.com/01topics/31probate/index.html.

Like Yahoo, Findlaw is organized into major subject areas with reviewed links listed under each subject heading. The Findlaw Section on Wills, Trusts, Estates and Probate covers a number of subjects including:

- Laws and government documents
- Journals, newsletters, and articles
- Mailing lists and Usenet groups
- Government agencies
- Outlines
- Software
- Law Firms Online

FindLaw began as a list of Internet resources prepared for a workshop of the Northern California Law Librarians. They felt that the pages could be useful to others as well, so they put the pages on the web and FindLaw was born. FindLaw has won numerous honors and awards since its inception. The FindLaw site is updated continuously so check it frequently to find new sites.

LINKS

If you feel you must see every estate planning site on the Internet, there are several sites that attempt to compile comprehensive lists. Be aware that most of these link pages list sites without any attempt at qualitative judgment, but you may stumble upon a golden site among the dross:

- Adam Kirwan's Legal Links and Search Engines Page—http://www.estate-planning.net/links.htm
- Dr. Travel's Estate Planning Page—http://www.drtavel.com/EP.html
- Law & Estate Planning Sites on the Internet—http://www.value.net/~markwelch/links.htm
- Estate Planning Links—http://members.aol.com/dmk58/epl.html

Estate Planning for the Consumer

A large segment of the estate planning sites on the Internet are consumer oriented. While many of these sites are excellent, the information is usually too basic to be of assistance to most practitioners. However, these sites can provide information for your clients: Two of the best consumer sites are the Nolo Press site (www.nolo.com/ChunkEP/EP.index.html), and the Estate Planning Center at Mississippi State University (www.ces.msstate.edu/pubs/pub1373.htm).

IT HAPPENS TO EVERYONE

Check out the estate planning efforts of the rich, the famous, and the merely interesting at the Wills of Celebrities and Ordinary People web site (http://www.ca-probate.com/wills.htm). This site contains the wills of celebrities including Elvis Presley, Princess Diana, Jackie Onassis, and Richard Nixon. In addition, this site includes wills of more ordinary folk dating back several hundred years. There is even a special section featuring the wills of thirty-five descendants of Dr. Godfrey Spruill dating back to 1718. The site is updated frequently. Information about the status of Frank Sinatra's will was on this site the day following his death. (If you are not sure whether your favorite celebrity is still among us, check out the You're Outta Here website of celebrity obituaries at http://www.cjnetworks.com/~roryb/outta.html).

IF IT IS NOT HERE, IT WILL BE SOON

The Internet should not be your only source for estate planning information. It only *seems* as if everything is on the web. Check your local library, or the AICPA library, for more information.

Internet use is increasing among attorneys and CPAs, the two groups most likely to use and to publish information on estate planning. So look for the amount (and hopefully the quality) of estate planning information on the Internet to increase over the coming years. CE

A settlement will also more likely preserve the confidentiality of the issues, thereby avoiding the possibility that the litigation itself may trigger discovery by the tax authorities.

Continued from page 5

partnership interest had been sold. The plaintiff may assert that valuation of the additional basis in the partnership is speculative. Depending on the facts, these assertions may or may not be persuasive. However, it is also noteworthy to point out that the plaintiffs can frequently control when those future benefits are to be realized.

Valuation of uncertain outcomes also becomes necessary if the resolution of the underlying tax problem has not occurred by the time of trial. There are several reasons for this unexpected situation. First, in some jurisdictions the statute of limitations for filing the malpractice lawsuit may begin when the defendant performed the tax work, as opposed to when it was discovered by the plaintiff (when the IRS made an assessment.) Therefore the malpractice lawsuit may be filed quickly before the underlying tax issue is resolved through appellate or litigation procedures, and preliminary damage calculations may be necessary.

The plaintiff or its subsequent advisors sometimes identify problems in prior tax returns before it is known if the returns will ever be selected for audit. Also, the resolution of federal tax issues often precedes determination for state income tax purposes since federal income tax adjustments are eventually reported to state income tax authorities. However, if the malpractice claim asserts that the advisor missed deadlines to contest an audit finding at the federal level, it may still be possible to contest the state income tax consequences.

SETTLING

When significant uncertainties exist, a settlement offers many advantages over litigation. For instance, a settlement may include an indemnification whereby the defendant is required to contribute to the fees required to resolve the tax issue and to bear or share in the tax cost of an adverse resolution. In the case of tax issues that have not been detected by the authorities, the indemnification would remain in effect until the subject tax period is no longer subject to assessment. A settlement will also more likely preserve the confidentiality of the issues, thereby avoiding the possibility that the litigation itself may trigger discovery by the tax authorities. Finally, as in other forms of litigation, a settlement may enhance the parties' ability to properly structure settlements with favorable tax characteristics.

Since issues relating to the taxability of recoveries are often not clear, the defendant may be justifiably wary that the plaintiff has grossed-up its damage calculation to account for a taxable recovery, but will adopt the tax return position that the recovery is not taxable. Settlement may provide the defendant with the opportunity to pay an amount that is not grossed-up and to provide a further payment in the event that plaintiff's tax return is successfully challenged by the IRS with respect to omission of the recovery. However, in practice the defendant or its insurance carrier will usually want to end the controversy once and for all, for reasons which include the possibility that there might be a subsequent dispute over performance under the indemnification agreement.

One way to deal with uncertain and widely disparate tax outcomes is to compute damages based on the weighted average probabilities of the possible outcomes, expressed in terms of present values. Such a technique is frequently used in other forms of commercial litigation, such as future costs of environmental cleanups. My experience, however, is that both plaintiff and defense malpractice attorneys may disfavor this probabilistic approach even though it seems to make economic sense in many circumstances. One reason given is that the use of probabilities may be considered to be speculative. Also, the Court may rule that the proper method of addressing uncertainty in respect to audit or Tax Court results is by expert testimony as to the most likely resolution of the issues, assuming that the IRS addresses them. However, I am informed it is not unusual for attorneys with considerable experience in defending claims for a major accountants' malpractice carrier to utilize a probabilistic damage calculation approach, at least in the claims settlement process. Therefore, the expert may be asked to prepare or critique a damage calculation based on probabilities of several outcomes.

PREPARING DAMAGE COMPUTATIONS

The first requirement for preparing damage computations is software that will compute IRS and state penalties and interest. As tax practitioners know, software is available that is flexible, provides detailed output, handles multiple scenarios, and makes the computations to a particular date. This software is also used to validate the computation of the IRS assessments that are the reason for the malpractice litigation.

I have usually prepared damage computations on spreadsheets that compare the results of actual and but-for cash flows. These cash flow schedules have further detail for each of the various penalties, federal tax payments, state tax payments, fees at issue, the federal tax benefit of state tax payments, and interest and other time value of money computations. Each viable theory of improper mitigation requires a separate calculation.

Preparation of several damage computations for purposes of preliminary evaluations may raise issues related to production to the opposing party, assuming that the preparer of the calculations is also a testifying expert. Nevertheless, since damages in these cases are often not so easy to estimate without detailed calculations, the clients usually want to see various damage computations at an early stage.

In addition, calculation of the tax, interest, and penalty cost for each issue in the plaintiff's return may be necessary. Consider, for instance, a payment made to the IRS based on three issues in a tax return. The plaintiff has asserted that the payment would not have been necessary if the defendant had prepared or caused a Tax Court petition to be prepared in time. The trier of fact was to determine which of the issues could have been resolved ultimately in the taxpayer's favor. If there are three issues, and two theories of improper mitigation, there will in theory be sixteen outcomes and possible alternative damage computations.[10]

It may be necessary for the expert to calculate the effects of differing outcomes very rapidly, in order to keep pace with the progress of a mediation, settlement conference, or trial. This will require the development or use of software that can be very flexible in calculating damages under the various scenarios that may emerge from such proceedings.

Tax planning and return preparation software may be useful in order to efficiently compute taxes for the many future tax years that were affected by alleged malpractice occurring in a single tax year. In 1996 and 1997, I prepared several damage calculations stemming from tax years prior to the advent of PC-based tax software or for years the software publisher no longer supported the software. This situation occurs because tax malpractice litigation is often conducted after resolution of the issues with the tax authorities, which can take years to accomplish. This also means that an expert who has first-hand experience with older versions of the tax law may be more likely to be engaged because of his or her ability to testify as to historical practices of tax professionals, as well as being able to quickly recognize the issues involved.

The liability expert is almost always a present or former tax practitioner because he must opine on the propriety of the defendant's procedures and the proper interpretation of the tax law at issue. If the damage expert is a different person, he or she will perhaps need fewer tax credentials, but will need to know or learn the areas of the tax law which affect the damage calculation itself. These areas can be numerous in some cases. As a result, the damage expert's effectiveness may depend on skill as a litigation consultant or testifying expert as well as a significant tax background. If the defendant is a CPA as opposed to an attorney, CPA damage experts for both litigants are more likely to also be assigned a role in the evaluation of the defendant's adherence to professional standards and the standards of care as they relate to CPAs.

Perhaps the most important recommendation is that the expert should communicate as many issues as possible to counsel before the damage calculations are started, and should ask questions about non-tax law that may influence the form of damage computations. Counsel's responses may reduce the number of scenarios that need to be considered. This process will also facilitate the selection of a relatively simple damage calculation in order to make a straightforward presentation, which is of paramount importance in these cases. CE

The damage expert's effectiveness may depend on skill as a litigation consultant or testifying expert as well as a significant tax background.

[10] If none, one, two, or three issues could have been won, the formula for the number of outcomes is 2^n multiplied by 2 theories of mitigation, where n (3) is the number of audit issues.

EXPERT *Opinion*

WHEN THE FUTURE BECOMES THE PAST

Accounting Firm Ignores Post-Valuation Date Information In Its Valuation Analysis

James R. Hitchner, CPA, ABV

Many valuation practitioners believe it is inappropriate to use post-valuation date information to set the value of a closely held security. However, in the *Estate of Emanuel Trompeter v. Commissioner of Internal Revenue* (T.C.M. 1998-35), reported January 27, 1998, the Court made an exception to this "rule" based on certain perceived facts and circumstances. Using a redemption price from a transaction that took place sixteen months after the valuation date, the Court determined the value of decedent's 1,533.482 shares of Series A exchangeable preferred stock of Sterling Holding Company ("Sterling" or "Company"), a closely held company. The date of valuation was the alternate valuation date, September 18, 1992. The Estate held that the aggregate value of the preferred shares was $15,335. The IRS revalued the shares at $1,974,845. The Court also determined that the Estate was liable for the fraud penalty based on the preferred stock and other assets held in the estate. Presiding was Judge David Laro.

Holders of Sterling preferred stock were entitled to receive preferential dividends on the $1,000 liquidation value of the stock, when and as the dividends were declared by the Board of Directors. They were entitled to certain liquidation preferences as well. Dividends accrued daily at the annual rate of 8.5 percent in 1989, 9.83 percent in 1990, 11.17 percent in 1991, and 12.5 percent from the beginning of 1992 through the date on which Sterling preferred stock was either redeemed or exchanged. Furthermore, Sterling had a mandatory obligation to redeem 1,000 shares of the Sterling preferred stock on December 31, 1993, 1994, and 1995. There were restrictions on redemptions and prepayments of dividends based on various debt covenants. These debt covenants essentially addressed Sterling's profitability.

Sterling's net sales as of December, 1992 were approximately $22 million. The Company had income before income taxes of $877,470 in 1992 with losses of $5.2 million in 1991 and $1.9 million in 1990. However, much of these losses were driven by non-cash expenses such as amortization of goodwill and intangible assets.

As of September 18, 1992, Sterling had a positive cash flow and was timely in paying interest and principle on its senior debt. It was also sufficiently paying its monthly operating expenses.

VALUE CONCLUSIONS

On the decedent's Federal estate tax return, the Estate reported the value at $10 per share for a total value of $15,335. On January 17, 1994, sixteen months after the valuation date, Sterling redeemed the preferred stock at $1,000 per share plus accrued dividends. The preferred stockholders accepted 5 percent interest in lieu of accrued dividends. The total amount paid to the Estate for the preferred stock was $1,947,845, which was the value that the IRS used.

ACCOUNTING FIRM ANALYSIS

Following the decedent's death, the coexecutors of the Estate retained an accounting firm. The Court felt that the accounting firm "...arbitrarily chose on May 1993 to report the total value of the decedent's Sterling preferred stock at $15,335" despite the awareness of the accountants and the coexecutors "...that prior valuations of [decedent's] stock had been much greater than $15,335, and at least one recent appraisal had listed the value of his stock in excess of $3 million." The Court also listened to evidence indicating that the accounting firm "had also valued the decedent's stock one month earlier at $462,000, a value which included a 70-percent discount that [the accountant] believed applied primarily to take into account the decedent's minority interest and the fact the stock was not paying dividends."

FRAUD CLAIMED

The IRS claimed that the Estate, acting through its coexecutors "(1) Attempted to conceal assets from the Government, (2) intentionally undervalued assets, and (3) intentionally overvalued deductions." However, the Estate argued that it did not commit fraud." According to the Estate, it may have misvalued some of the reported

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assets and deductions, and failed to report some other assets, but it did not do so with requisite fraudulent intent."

HYPOTHETICAL BUYER AND SELLER

In determining fair market value, the Court indicated that "If actual sales are not available, fair market value is determined based on a hypothetical willing buyer and a hypothetical willing seller. These hypothetical persons are not specific individuals or entities, and their hypothetical characteristics may differ from the personal characteristics of the actual seller or a particular buyer." As always, the standard of value in tax cases is fair market value, with the hypothetical buyer and seller concept. It's important to note that in other courts or in other situations, the definition of fair market value or the standard of value may be different, such that the personal characteristics or intent of sellers and buyers may be reflected. This was not the situation in this tax case.

POST-VALUATION DATE INFORMATION

Concerning the use of post-valuation date information "The estate argues that facts concerning the redemption [of Sterling preferred stock] are irrelevant to our determination. The estate claims that the redemption was not foreseeable on the applicable valuation date of September 18, 1992, given Sterling's questionable financial condition and its failure to meet redemptions which were scheduled, but not made, before that date."

The Court disagreed with this assertion and opined that "We disagree with the estate that facts concerning the redemption are irrelevant to our determination of value. Although these facts may not necessarily set the fair market value of the Sterling preferred stock on the applicable valuation date, we believe they are relevant to our determination of that fair market value." The Court also indicated that adjustments to post-valuation date information can be made to account for the difference in time and circumstances due to changes from the date of valuation to date of the redemption.

The Court also disagreed with the Estate's assertion that Sterling's financial position was weak and that they were unable to redeem the stock as previously indicated. The Court looked at the financial statements from a cash flow perspective and noted that most, if not all, of the losses were attributable to amortization of intangible assets and deferred financing costs. The Court also noted that the fact that Sterling did not make partial redemptions in prior years was not indicative of a problem since they were not obligated to make redemptions, but only to make their best effort. The Court opined as follows: "That the Sterling preferred stock would be redeemed on or before the December 31, 1995, date set forth in the purchase agreement, at or about the price stated therein, was foreseeable on September 18, 1992, based on the facts available on that date."

Judge Laro made a very important distinction here. The subsequent event must be foreseeable at the date of valuation. What happens if the subsequent event is not foreseeable? The implication is that it would be given much less, or no weight.

FACTORS TO CONSIDER

The Court noted various factors that needed to be considered in valuing closely held stock by opining that "Unlisted stock may also be valued indirectly by reference to the subject corporation's net worth, its prospective earning power, its dividend-earning capacity, its goodwill, its management, its position in the industry, the economic outlook for its industry, the degree of control represented by the block of its stock to be valued, and the amount and type of nonoperating assets if not considered elsewhere." These factors are contained in Revenue Ruling 59-60 and in prior decisions by Judge Laro.

The Court also noted that a discount for lack of marketability would be appropriate when comparing unlisted stock with publicly traded stock.

IRS EXPERT

The IRS did not call an expert at the trial, but relied solely on the post-valuation date redemption price.

ESTATE'S EXPERT

Although the Estate reported the value of the preferred stock at $15,335, they presented an expert at trial who valued the shares at $184,018. The Estate's expert was accredited by the American Society of Appraisers and was previously a university professor of finance. He was currently a consultant in a firm that specialized in economic feasibility assessment and financial analyses.

As always, the standard of value in tax cases is fair market value, with the hypothetical buyer and seller concept.

The Estate's expert valued the preferred stock by comparing it to the price-to-book values of comparable publicly traded preferred stock issues that he found. "He concluded that the Sterling preferred stock was generally equivalent to a 'C' and/or 'D' rated security, and that the Sterling preferred stock was closer to a 'D' rating because it was nonpaying and much of Sterling's debt was 'technically' in default." Although he started with ten public preferred stock issues, he ultimately used three companies including TransWorld Airlines (TWA), Rymer Foods (Rymer), and SPI Holding (SPI). TWA was trading at 11 percent of its call price and was in bankruptcy at the time of the valuation. Rymer's preferred stock was trading at 10.9 percent of its call price, and SPI's preferred stock was trading at 12.5 percent of its call price. The Estate's expert chose a 15 percent multiple for the Sterling preferred stock because "an upward adjustment to the percentages derived from the comparable issues was necessary because Sterling had a positive cash-flow and was timely paying interest and principle on its senior debt."

The Estate's expert valued the company at $150 per share even though it had a $1,000 redemption price. He then reduced this value by 20 percent to reflect the stock's lack of marketability and opined at $184,018. The Court was "unpersuaded by [Estate expert's] analysis and opinion." The Court also felt that "The Sterling preferred stock was a better grade than a 'C' or 'D' rated security. In addition to the fact that Sterling was paying its monthly operating expenses, Sterling was servicing its senior debt."

The Court found further fault with the Estate's expert analysis by indicating that their expert "also relied inappropriately on companies that were not comparable to Sterling. TWA, for example, had filed for bankruptcy on January 31, 1992, and its auditor had expressed substantial doubt concerning its ability to continue as a going concern. Sterling, by contrast, was not in bankruptcy. Moreover, its 1990 through 1992 financial statements were accompanied by its auditor's unqualified opinion on the validity of those statements. Likewise, Rymer's financial status resembled that of TWA. Rymer had been told that its line of credit would not be renewed, which raised serious concerns that, absent its capitalization, it would be driven into bankruptcy. Nothing in the record persuades us that Sterling was on the verge of bankruptcy. To the contrary, the record indicates that Sterling was a viable entity that recapitalized primarily to alter its capital structure."

The proper choice of guideline public companies continues to be a hot button in the tax courts. There is a continuing trend toward dismissing these public companies because the courts feel they are not similar.

COURT PREPARES IT'S OWN VALUATION

Given the fact the IRS provided no expert witness testimony and that the Court completely disregarded the Estate's expert testimony, the Court decided to prepare its own valuation of the preferred stock. The Court indicated that "Sterling's mandatory obligation to redeem the stock, however, does establish a benchmark for determining the applicable value. We concluded above that it was foreseeable on September 18, 1992, that Sterling would redeem the Sterling preferred stock on or before December 31, 1995, at or about the price stated in the purchase agreement. We conclude similarly that a hypothetical willing buyer would have bought (and a hypothetical willing seller would have sold) the decedent's Sterling preferred stock on September 18, 1992, at a price that approximated the present value of the amounts that a holder of the decedent's Sterling preferred stock would have received for the mandatory redemptions."

The Court determined the amounts that would be due Sterling on each successive year according to the redemption formula ($871,023, $986,978, and $1,118,368) and determined the present value of those amounts at a discount rate of 4 percent ($827,298 + $900,676 + $980, 562). This analysis led to a fair market value of Sterling preferred stock of approximately $2.7 million (Neither side presented evidence of a value that high, so the Court opined that the IRS's determination of value was appropriate which was $1,947,845.

FRAUD

Concerning the issue of fraud, the Court opined that "When we view the record as a whole, we conclude, clearly and convincingly, that the estate intentionally undervalued the decedent's taxable Estate, and that the Estate did so with the specific intent of evading tax." The Court went on to indicate that the

Estate's undervaluation of the preferred stock was significant. The Court noted that the Estate's valuation of the preferred stock was less than one percent of the Court's determination of value and that the Estate attempted to blame the accountants for the undervaluation of the preferred stock. The Court indicated, however, that at least one of the coexecutors knew about the accountant's prior valuation work and that the coexecutor had the education and business acumen to know better.

CONCLUSION

This situation offered an ideal opportunity for the Estate and the accountants to provide a "bridge valuation." A bridge valuation takes what is known as of the valuation date and compares this to the subsequent event, which here was the redemption of the preferred stock sixteen months after the valuation date. There should have been a clear and concise explanation of why the values differed. Had this been done ahead of time, the Court may have come to a different conclusion. Given the facts presented, it was difficult for the Court to come to any other opinion.

It is interesting to note that there was no mention of consideration given to Revenue Ruling 83-120, which outlines the procedures and factors to consider in valuing preferred stock. It is a fairly good ruling which presents various coverage and other ratios to consider when making comparisons to public preferred stock issues. This type of analysis may have resulted in a different value. CE

TIP of the Issue

ENGAGEMENT LETTERS: MINIMIZE RISK, MAXIMIZE FEES

Michael J. Mard, CPA/ABV, ASA, and R. Wade Wetherington, Esq.

We have a saying in our office: "If you don't have it, you ain't got it." If the professional service has been provided, the client often has no incentive to pay, especially if the service is related to an unpleasant event involving litigation. The client may be frustrated by the outcome of litigation or an IRS-related matter and may take that frustration out on the nearest professional (the kick the dog syndrome). Put another way, the client often has incentive to not pay if the service has been provided.

All is not lost; you have some influence over this process. A tight engagement letter can present a streamlined agreement between you and the client that specifies dispute resolution and indemnification. With such a letter, you can ensure collection of your fees and minimize or prevent retaliatory lawsuits intended as leverage that make unwarranted claims of malpractice, negligence, breach of duty, deviation from standard of care, or the failure to follow industry standards.

Typically if an accountant threatens to enforce collection of fees by suing, the client responds with a claim (warranted or not) of malpractice. Under common law, accountants generally can be sued by clients for poor advice and for failing to detect a client's intentional or unintentional departure from accepted practice. The statute of limitations generally allows a client to sue for a period of two years from the time the problem is or should have been discovered. Importantly, the ability to sue is limited to persons in privity with the accountant. If you are not in privity by written contract, you are vulnerable to malpractice claims under common law, not only from your client but also from third parties who rely upon your work product.

Liability to third parties may arise from gross negligence such as reckless or willful acts, prior knowledge of the accountant that the third party intended to rely upon the information, or fraud, misrepresentation, or concealment. Information is often supplied to the accountant negligently (see, for example, *Mattco Forge, Inc. v. Arthur Young & Co.*, 5 Cal. App., 4th 392, Cal. Rprt.2d, April 1992). Playing no part in developing the negligently prepared information does not always get the CPA off the hook. But under common law, collection of fees, professional malpractice, negligence, breach of duty, deviation from standard of care, and failure to follow indus-

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A Checklist of Items to be Included in Engagement Letters

- ☐ Identification of client
- ☐ Identification of users
- ☐ Detailed description of entity or interest to be valued
- ☐ The "as of" date of the valuation
- ☐ Definition of value to be used
- ☐ Premises of value to be used:
  - ☐ Marketable or nonmarketable
  - ☐ Going-concern or liquidation
  - ☐ Ownership characteristics
  - ☐ Control or minority
  - ☐ Special minority rights by size of holding (varies by state)
- ☐ Consent to contact CPA or prior CPAs
- ☐ Client responsible to review and confirm factual contents of report
- ☐ Party responsible for payment of fees
- ☐ Determination of fees
- ☐ Timing of engagement
- ☐ Timing of fee payments
- ☐ Additional services available (e.g., expert testimony)
- ☐ Fees for additional services
- ☐ Type of report to be provided
- ☐ Responsibilities of client
- ☐ Responsibilities of valuator
- ☐ Confidentiality and subpoena of CPA's records
- ☐ Standards to be applied (AICPA, USPAP, other associations)
- ☐ Management's representation letter to be provided (include draft of typical letter)
- ☐ Ability to withdraw from the engagement if fees are not paid
- ☐ Scope restrictions
- ☐ Use of alternative dispute resolution
- ☐ Use of specialists or cooperative engagements
- ☐ Statement of assumptions and limiting conditions

try standards can be controlled or avoided entirely by the use of engagement letters.

ENGAGEMENT LETTERS

The use of engagement letters is discussed at length in the AICPA Consulting Services Practice Aid 95-2, *Communicating Understandings in Litigation Services: Engagement Letters.* (New York:, AICPA, 1995). Generally, engagement letters satisfy several purposes including:

▲ Establishing a clear understanding of services.

▲ Defining the responsibilities and scope of the CPA and the client.

▲ Communicating and documenting this understanding with the client.

▲ Limiting the scope of services provided by the CPA.

▲ Communicating an understanding of fees, billing arrangements, and the client's obligation to pay the fees.

▲ Limiting the client's expectations of the product of the CPA services.

▲ Limiting the use of the product by non-clients and third parties.

Litigation services present a dilemma for the CPA as expert. Often, the referring attorney does not yet know the entire scope of the CPA's services and may not want to limit that scope in writing. If the scope is too narrowly defined, the opposing attorney may use this fact to attempt to impeach the expert by demonstrating a conflict between the work performed and the scope of the engagement. In such a case, the expert without an engagement letter is exposed to a claim of malpractice, protected only by a relationship with an attorney who is representing someone else.

Many experts try to bridge this gap with a limited engagement letter of perhaps one page which provides broad statements of scope of services and responsibilities. Unfortunately, the ambiguities resulting from this approach might provide the basis for a malpractice claim as well.

ELEMENTS OF AN ENGAGEMENT LETTER

Generally, the engagement letter should be a flexible document with simple language. (See the sidebar on this page for a list of items that should be included in an engagement letter.) While you may have a template version of the engagement letter, the specific terms of the engagement related to a specific

The Lucky 13

Rules to Ensure the Continued Success of Your Litigation Practice

1. Always get the engagement letter signed; if jointly retained, get it signed by both parties.

2. Always include an indemnification clause.

3. Insist upon an arbitration process to resolve fee disputes.

4. Remember that lawyers are professional associates, not your friends. Lawyers have only one client, and it is not you.

5. Unethical lawyers frequently misrepresent in the name of advocacy.

6. Incompetent lawyers frequently misrepresent in the name of good faith.

7. Do not believe lawyers when they say they will protect you on your fee.

8. A judge who may appoint you to the court or may sign an order jointly stipulating to your opinion is not your collection judge.

9. The existence of a court order does not mean that a client can be forced to pay you.

10. Work out of a retainer. (Simple to say, but hard to do.) Determine a "refueling" level, and once your fees reach that level, issue an invoice for another retainer.

11. When the client tells you he cannot pay, trigger the engagement letter termination clause.

12. The client's problems are not your problems, unless you continue to work without payment of your fee.

13. If the client stiffs you, assess your risks, then take action to invoke your arbitration clause.

fact issue should be negotiable.

Some of the most important elements of an engagement letter for a litigation services engagement are:

1. Define the attorney as client, the attorney's client as your client, or both. With the attorney involved, there is some work product protection, but this protection typically ends when you are listed as expert.

2. Identify the client and be sure to identify the exact name of the company on which your scope of work will be centered.

3. Identify the litigation by naming the litigants, the name of the court, and the docket number.

4. Describe the nature of the litigation services and define specifically the services to be provided including the relevant time period.

5. Clearly state the purpose of the services.

6. Specify the applicable professional standards and be clear about your final work product, whether it will be a full self-contained written report, a summary report, or an oral report with only supporting work papers. The AICPA's Statement on Consulting Services (SSCS) No. 1 requires the CPA to provide a report to the client, but does not specify the form of the report.

7. Specify the responsibilities of the client to provide accurate and complete information, including an understanding that the client will provide you with the basic information required upon which you will rely and that the client is responsible for the accuracy and completeness of that information.

8. Specify also what you will not do, such as your having no responsibility to detect fraud or illegal acts, if the engagement circumstances potentially involve such acts.

9. Specify that the client will provide unrestricted access to senior management and key employees, facilities, books, and records.

10. Identify the individual who will be providing the expert opinion (this may be you or someone else in your firm).

11. Include restrictions on the use of or exposure of your work product to the case at hand. Any written reports or other documents prepared should not be allowed to be published or used for any other purpose without your written consent.

12. State clearly any other past or present work you have performed for the client, the opposing party, or the attorney.

13. Specify the terms of your engagement and that if any of the terms of the engagement (including scope, information provided, and fees) are altered, you reserve the right to unilaterally withdraw from the engagement.

14. Make sure the engagement letter contains an indemnification clause, perhaps the most important clause in the letter. This clause will provide that the expert shall be held harmless from liability and indemnified

While the indemnification clause may be the most important clause in the engagement letter, the fee provisions will be held closest and dearest to heart.

as to damages. Specify that the client will hold you and your firm harmless from liabilities including costs and expenses related to the engagement.

FEES

While the indemnification clause may be the most important clause in the engagement letter, the fee provisions will be held closest and dearest to heart. Make it clear that your fees cannot be contingent on the outcome of a trial, if any, and cannot be based upon commission. Specify that the hourly rates are subject to change (some litigation lasts for years).

The engagement letter should require that fees be paid up to issuance of the report and that a retainer be made for deposition and trial testimony. Invoices not paid on a timely basis should be subject to a stiff interest rate. The engagement letter can be very specific as to fee and billing arrangements.

Alternative dispute resolution (ADR) is a formidable tool in resolving fee matters while minimizing malpractice exposure. ADR includes arbitration (binding or non-binding) and mediation. Some insurance carriers (and some lawyers) reject ADR. However, if you can use an ADR clause to resolve any fee disputes, you may gain several benefits. You can preempt the right to a jury trial and avoid extensive discovery, leading to a quicker resolution at less cost. Typically there is no appeal. This can be to your disadvantage sometimes, but at least you will know the matter is over.

JOINT HIRES

Should you get an engagement letter when you are court appointed or jointly retained? The answer is a resounding yes. The judge who may appoint you to the court or may sign an order jointly stipulating to your opinion is not your collection judge. The judge may rotate off the bench or may simply refuse to insist on the payment of your fees without a special hearing or in a separate venue. If you are court appointed or jointly stipulated, get your engagement letter signed by both parties. This simple act takes your matter out of common law and puts it into contract law pursuant to the terms of your contract, which should include an arbitration clause to facilitate fee collection.

Litigation services are hard enough without doing them for free. Insist upon a thorough engagement letter that clarifies dispute resolution and indemnification in order to minimize your risk and maximize your fee collections. CE

Further discussion of using ADR in engagement letters is in "Tip of the Issue: Using ADR Clauses to Manage Collections," by Melinda M. Harper, CPA, in CPA Expert *(Summer 1997).*

FYI...

DAUBERT REVISITED

As a follow-up to the article "Avoiding the Pitfalls of a Daubert Challenge," by Roman Silberfeld, JD (*CPA Expert,* Winter 1998), we reprint the following article from the February 1998 issue (vol.2, no.2) of *Mealey's Daubert Report,* a newsletter. The article is reprinted with permission (© *Mealey's Daubert Report* 1998).

JOINER CITED IN AFFIRMING STRIKING OF TESTIMONY

CHICAGO—Citing the Supreme Court's recent decision in *Joiner v. General Electric,* the Seventh Circuit U.S. Court of Appeals has affirmed a trial judge's striking of the testimony of an accountant offered by the plaintiff in a breach of contract suit (*Target Market Publishing Inc. v. ADVO, Inc.,* No. 97-1979, 7th Cir.).

The Seventh Circuit pointed to *Joiner,* which stated: "A court may conclude that there is simply too great an analytical gap between the data and the opinion proffered."

Additionally, the Seventh Circuit rejected plaintiff's contention that trial courts are required to hold a hearing *in limine* prior to excluding expert evidence.

The parties in the case entered into a one-year contract to produce a direct mail advertising publication.

A dispute erupted when defendant ADVO Inc. decided that the publication was no longer viable in the Cleveland market and ceased publication. Plaintiff Target Market Publishing asserted that the drop in advertising in Cleveland was due to ADVO's failure to adequately support its sales staff.

Efforts to sell advertising in New Orleans and Baton Rouge, Louisiana, also failed.

ADVO eventually notified Target that it would cease performing under the contract. Target reacted by suing ADVO for breach of contract and breach of fiduciary duty.

The trial court granted a motion for summary judgment, holding that Target could not possibly meet its $50,000 jurisdictional minimum requirement.

Target had relied on an expert report prepared by Bruce W. Burton, an accountant with Deloitte & Touche. The Burton report concluded that Target should have earned $1.4 million as a result of the joint venture agreement. ADVO countered that the Burton report was pure speculation and was based on unreliable methodology.

Although it never mentioned it was reviewing the Burton report under *Daubert* standards, the district court granted summary judgment because Target "relies upon mere assumptions...from which no reasonable inference of lost profits could be drawn."

On appeal, Target asserted that the district court impermissibly weighed evidence that was properly reserved for the fact finder at trial. ADVO countered by arguing the trial judge had in fact excluded the Burton report based on *Daubert*—even though the trial judge never explicitly stated he had made the ruling based on those standards.

The Seventh Circuit noted the trial court's ruling on the Burton report was "rather cryptic." It also noted that the trial judge had said "the entire body of evidence that is not mere speculation does not support an award of lost profits that satisfies the jurisdictional minimum." Target interpreted this to mean that the trial court actually admitted the Burton report and considered but then impermissibly determined that it was entitled to little or no weight because of its speculative nature.

But the Seventh Circuit cited the Supreme Court's recent *Joiner* language as to why the trial court did not abuse its discretion in barring the testimony. The court noted that the plaintiff had to rely on assumptions made by Burton in his report and the trial judge correctly felt that the "optimistic assumptions" were not plausible.

MORE ON DAUBERT

The U.S. Supreme Court will revisit the issue of controversial expert testimony. Since the Daubert ruling in 1993, lower courts have been divided about what kind of expert testimony qualifies as "scientific" rather than "junk science." In *Kumho Tire v. Carmichael*, the plaintiffs sued Kumho, a South Korean tire manufacturer. The trial judge excluded the testimony of an engineer who supported the claim that a defective tire on the plaintiff's van had caused an accident. The federal appeals court in Atlanta reversed that decision, saying the 1993 ruling didn't apply because the expert wasn't relying on "scientific principles."

TWO STRONG GROWTH AREAS: BUSINESS VALUATIONS AND LITIGATION SERVICES

Business valuations was at the top of the list of growth areas for CPA firms, according to the 1998 survey of *Accounting Today*'s Top 100 Tax and Accounting Firms. Business valua-

Mark Your Calendars!

Several AICPA conferences of interest to *CPA Expert* readers are scheduled for Summer and Fall 1998:

Fraud Conference
September 17–18, 1998
(Optional session September 16)
Caesars Palace, Las Vegas, Nevada

Advanced Litigation Services Conference
October 15–16, 1998
The Buttes Resort, Tempe, Arizona

Business Valuation Conference
November 15–17, 1998
Loews Miami Beach, Florida

For information about these conferences, contact AICPA Conference Registration 888-777-7077.

tions was selected by 82 percent of the firms and litigation services by 68 percent. Only technology consulting ranked higher than litigation services at 73 percent. The growth in business valuations is attributed to a booming economy that is creating more opportunity.

GUIDANCE ON PROVIDING BANKRUPTCY SERVICES

Bankruptcy, insolvency, and reorganization account for a significant segment of business conducted by CPAs. The services of CPAs, including attest, tax, and general consulting services, are needed by attorneys, debtors, creditors, courts, and owners throughout the bankruptcy process. To help CPAs understand their role in bankruptcy matters in the context of litigation services, the Management Consulting Services team has published Consulting Services Practice Aid 98-1, *Providing Bankruptcy and Reorganization Services: A Nonauthoritative Guide* (New York: AICPA, 1998). The practice aid provides an overview of the bankruptcy code and the bankruptcy process. It covers the employment process and fee applications related to accountants in the various roles they may be engaged to play in a bankruptcy proceeding. Other sections focus on bankruptcy schedules and statements, business operations during bankruptcy, avoidance powers, financial reporting during the reorganization and upon emergence from chapter 11, determination of claims and interest, plan of reorganization, application of the CPA's report to the proceedings, and income tax issues.

The authors are F. Wayne Elggren, partner, and R. Todd Neilson, partner, Neilson, Elggren, Durkin and Company; Marilee Keller Hopkins, partner, Crowe Chizek and Company, LLP; Grant W. Newton, Pepperdine University; and M. Freddie Reiss, partner, Price Waterhouse, LLP. Editorial assistance was provided by David P. Leibowitz, partner, Freeborn & Peters, Chicago, Illinois. To obtain a copy, call the AICPA at 888-777-7077 and ask for product no. 055162CX. Members of the MCS Section receive Consulting Services Practice Aids gratis. CE

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